
UNIT 3 INTERNATIONAL MONETARY SYSTEM

After going through this unit, you should be able to understand:

- the meaning and scope of international monetary system;
- exchange rate arrangement;
- exchange rate arrangement in the pre-IMF period;
- commodity specie standard;
- gold standard;
- IMF's fixed parity system of exchange rate (1945-1973); IMF's present system of exchange rate (since 1973); and
- IMF and International Liquidity.

Structure

- 3.1 Introduction
- 3.2 Exchange Rate Arrangement
- 3.3 IMF and International Liquidity
- 3.4 Summary
- 3.5 Self Assessment Questions
- 3.6 Further Readings

3.1 INTRODUCTION

The term, international monetary system, refers to the institutions, norms and the entire environment that facilitate the settlement of international payments. We can take a simple example here. Suppose you have to pay for the import invoiced in US dollar; You will go to your banker to get US dollars for rupees. If you are an exporter getting euro, you will go to your banker to convert euros into rupees. This is nothing but the exchange of currencies. There are many other cases where currency is exchanged.

Whenever one currency is exchanged for the other, a basic question arises as to how many units of a currency would be foregone to fetch one unit of the other currency. This is the question of the relationship between value of two currencies exchanged. In common terminology, it is known as the exchange rate. Exchange rate thus plays a vital role in the settlement of international payments and so any arrangement in this context forms the subject matter of the international monetary system.

Besides the exchange rate arrangement, it is the ability of a country to pay that lies at the root of the settlement of international payments. The ability to pay is interpreted in terms of liquidity. A country should have the desired liquidity to make international payments. A country's liquidity is necessarily tagged with the international liquidity. It is the International Monetary Fund (IMF) whose main concern is to maintain and improve international liquidity. Thus any discussion of the IMF's role in maintaining international liquidity too forms the subject-matter of the international monetary system.

3.2 EXCHANGE RATE ARRANGEMENT

The nature of exchange rate arrangement has undergone changes over past couple of centuries. There was a time when costly metal was used as medium of international



exchange of commodities under a specific arrangement, known as commodity specie standard. It was followed by gold standard that was a more sophisticated version of the exchange rate arrangement and that had set rules. It enjoyed merits, but at the same time, there were some limitations to that system that led to its suspension for some time and subsequently to its abandonment. The abandonment of the gold standard led to upheavals in the exchange rates and then to check it, the-IMF was established. These different regimes need some explanation.

Commodity Specie Standard

Under the commodity specie standard, the value of the commodities was expressed in terms of gold and silver coins that were used for the settlement of international payments. There was a fixed ratio between the gold coin and the silver coin. It was known as the mint ratio. For example, the mint ratio was 15.5: 1 between silver and gold coins in France during the early nineteenth century.

In many cases, coins were full-bodied coins meaning that the value of the metal used in the coin was the same as its face value. In other cases, there were debased coins with greater face value than the value of the metal used in them.

Gold Standard

Although pound had been minted of gold as far back as in the 17th century, gold standard originated in England in 1816 when gold became the official tender. By 1870s, gold standard stood widely accepted among countries and it reigned with full fervour till the outbreak of the Great War in 1914.

Forms

Gold standard had three forms; One was the gold specie standard in which coins were minted of gold. The paper currency could be converted into gold on demand. The price of gold was fixed under law. The second form was the gold bullion standard with no compulsion to mint gold coins. Paper currency was not convertible into gold on demand; rather gold bars could be bought from the central bank at fixed rates. The third was the gold exchange standard with no compulsion to mint gold coins, nor the exchange of paper currency into gold either on demand or through purchase of gold bars. The currency being on gold exchange standard was convertible into the currency being on the gold specie standard and the latter was convertible into gold. For example, rouble could be exchanged for gold via British pound.

Whatever the form might be, there was no restriction on the inter-country flow of gold. The central bank of a gold-specie/ gold bullion standard country did have 100 per cent backing of gold behind its currency.

Broad Rules

The broad rules of the gold standard were manifest in automatic mechanism for;

1. Fixed exchange rates
2. Adjustment in the balance of payments
3. Domestic price stability

The exchange rate depended upon the content of gold in different currencies. In practice, one ounce of gold was then valued at £ 4.24 and the same weight of gold with similar fineness was valued at \$ 20.67. Naturally, one pound was exchanged for \$ 20.67 14.24 or \$ 4.87. This rate was known as mint parity or mint exchange rate. The actual exchange rate remained close to mint parity because free flow of gold between two countries helped avoid any major deviation. Suppose the value of dollar depreciated to \$ 5.25/£, the arbitraguer would buy one ounce of gold in the United



States for \$ 20.67 and sell it in the United Kingdom for £ 4.24 and then they could exchange the pound for dollar in the foreign exchange market for \$ $5.25 \times 4.24 = \$ 22.26$. This brought them a profit of \$ $22.26 - 20.67 = \$ 1.59$. The process of arbitrage continued till the original parity was reestablished. It may be noted that this process involved transaction cost or transportation cost of gold that might not help equate the actual exchange rate to mint parity. But the difference from the mint parity was limited to only that amount.

Turning to automatic adjustment in the balance of payments, one finds that any deficit was made up through price-specie flow. Suppose that England faced a deficit on trade account. It could lead to outflow of gold for the settlement of trade. The outflow of gold lessened the money supply within the country. The emerging deflation in the wake of shrinkage of money supply would make the English exports competitive. This led to a rise in the export wiping out any deficit on this account.

There was one more explanation for automatic adjustment in the balance of payments. Reduced money supply raised interest rate. The banking system restricted credit in view of reduced money supply and to this end the central bank raised the bank rate. Ultimately, in lure of higher interest rate, foreign investment moved into the economy meeting any deficit on the capital account.

Last but not least, domestic price was stable. Currency was backed fully by gold. Money supply was constant in view of constant gold reserves. With constant money supply, prices were constant. Any deviation could occur only after discovery of gold mines that was the case in the USA when Californian gold mines were discovered in 1847. Prices increased and this increase was transmitted to other countries through the flow of gold.

Suspension and Subsequent Abandonment

Gold standard was not tenable during the War. It is because the War needed greater amount of money, but the printing of currency was not possible in view of 100 per cent backing of gold behind the currency. So it was suspended. After the War, when it was readopted, the international economic scenario was too different to sustain it, Germany and Austria were in the grip of hyperinflation. Pound stood over-valued when France devalued its currency. And again, the expansionary monetary policy was to be introduced to combat the Great Depression of 1930s that was not feasible under the gold standard. In short, the gold standard of the inter-War years failed to fit in the changed international economic scenario. Finally, the UK abandoned it in 1931. The USA got rid of it in 1933 and France took the step in 1936.

IMF and the Fixed Parity System

What led to the establishment of the IMF in 1945? In fact, after the abandonment of the gold standard, the exchange rate fluctuated widely. That, in turn, affected the global trade. It is true that the currency areas were created in 1930s. The intra-area exchange rate was fixed, but there was no control on the inter-currency area exchange rate. Thus in order to bring the situation under control, it was resolved at the Bretton Woods Conference of 1944 to create an international monetary institution that could design the exchange rate system based on then international economic scenario and could have surveillance over it. The IMF came into being as a Bretton Woods child.

Broad Features

What were the features of the exchange rate regime then designed? The exchange rate regime was known as the fixed parity system with adjustable pegs. In fact, it



was designed at Bretton Woods and so it was also known as the Bretton Woods exchange rate system.

In the fixed parity system, each member country was to set a fixed value-called the par value-of its currency in terms of gold or US dollar. It was the par value that determined the rate of exchange between two currencies. Minor fluctuations in the exchange rate within a narrow band of one per cent above and below the established parities could not be ruled out. They were to be corrected through active intervention of the monetary authorities of that country.

It may, however, be mentioned that the fixed parity under the Bretton Woods system was not like that of gold standard of 1880-1914. It was a fixed parity with adjustable pegs meaning that any member country could alter the value of its currency or, in other words, could devalue its currency in case of "fundamental disequilibrium" in the balance of payments. Changes up to five per cent did not require prior approval of the IMF, but beyond it, IMF's approval was necessary. Fundamental disequilibrium was never formally defined; but in practice, it meant continued and chronic balance of payments problem and colossal loss of reserves. The purpose of the adjustable peg system was, therefore, to establish a balance between the objectives of stable exchange rates and the macro-economic goals of the countries going for such adjustments as also to help avoid any use of exchange control and trade-restrictive measures. In other words, it brought flexibility in the fixed exchange rate system for the purpose of attaining equilibrium in the balance of payments. The provisions also contained cautions so that there might not be competitive devaluation. It was maintained through supervision and scrutiny over desired exchange rate changes.

Again, an important aspect of the Bretton Woods exchange rate system was that the US dollar was convertible into gold at a fixed rate of \$ 35 a troy ounce of gold. The other currencies were convertible into gold via US dollar. This currency was given the position of intervention currency in the system in view of the fact that in the immediate post-War period, it was the strongest currency. This system was, therefore, likened with the gold exchange standard where countries redeemed their currency into gold-convertible currency and not necessarily into gold directly. In the post-War system, the US dollar came to be the intervention currency what was the British pound during the early decades of the twentieth century.

Collapse of the system

The system performed well during 1940s and till late 1950s. The US dollar did do well as an intervention currency insofar as it was as good as gold in view of the strong position of the US economy. The central bank in many countries held the dollar-denominated securities as reserves. But when the US balance of payments began experiencing growing deficits on account of widening trade deficit and outflow of dollar, the real value of dollar turned lower compared to its nominal value. It shook confidence in dollar and the central banks began converting the US dollar denominated securities into gold. It led to the outflow of gold from the USA that in turn slashed further the real value of dollar. A vicious circle emerged between falling real value of dollar, loss of confidence in dollar, conversion of US dollar denominated securities into gold and the outflow of gold from the USA. The outflow of gold was so huge in August 1971 that the then President Nixon suspended the convertibility of US dollar into gold. This decision threatened the very fundamentals of the fixed parity system.

In order to bring back confidence in US dollar, the Smithsonian Committee resolutions of December 1971 devalued dollar and re-valued upwardly some major currencies. At the same time, the normal fluctuation band was widened to ± 2.25 per cent. But the Smithsonian measures failed to generate confidence. A few currencies came on



to float, and finally, the fixed parity system collapsed in February 1973.

A committee was formed to suggest a feasible system. The new system, as suggested by the Committee, provided various options to the member countries. The member countries adopted them depending upon their convenience, although the system was given a legal shape through amending the Articles of Agreement of the IMF that came into force from April 1978. The system is still in vogue.

Activity 1

1. What were the broad features of Bretton woods Exchange Rate System?
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2. What were the main reasons for the collapse of Bretton Woods Exchange Rate System?
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The Present System of Exchange Rate

The new/present system provides different options ranging from fixed to floating or even a hybrid of the two. The options are:

1. Fixed exchange rate
 - a) Pegging to a single currency
 - b) Pegging to a basket of currency
 - c) Pegging to SDRs
 - d) Currency board arrangement
- 2 Floating exchange rate
 - a) Independent floating
 - b) Managed floating
- 3 Crawling peg
- 4 Target-zone arrangement

If one looks at the options over a period of time, there is a definite shift in preference among the member countries in favour of floating exchange rate. At present, 35 out of 187 countries have an independent floating system. The other 51 countries have managed floating system. While 53 countries have some or the other kind of fixed exchange rate. 7 countries have gone for a crawling peg. The European Monetary Union (EMU) and other 20 countries of Africa and the Caribbean region have target-zone arrangement. Lastly 9 countries do not have their own currency as legal tender (IMF, 2005). Let us explain in brief the different kinds of options.

Fixed Exchange Rate

In a fixed exchange rate system, the government of a country can peg its currency to the currency of another country. It is normally done in a case where the other



currency accounts for a sizeable trade with that country. The currency of Bhutan is, for example, pegged to Indian rupee.

A currency can be pegged to a basket of currencies. Indian rupee was, for example, pegged to a basket of five currencies prior to 1993. The reason is that the appreciation and depreciation of currencies in the basket make the weighted average comparatively stable.

A few currencies were pegged to SDRs when the latter was more stable. But now no currency is pegged to SDRs.

Sometimes pegging is a legislative commitment that is often known as the currency board arrangement. The currency board pegs the domestic currency to another nation's currency and buys and sells foreign currency reserves in order to maintain the parity value. Again, it is a fact that the exchange rate is fixed in case of pegging, yet it fluctuates within a narrow margin of ± 1.0 per cent around the central rate. On the contrary, in some countries, the fluctuation band is wider and the arrangement is known as pegged exchange rates within horizontal bands.

Floating Exchange Rate

Floating exchange rate is determined by the market forces of supply and demand. A particular currency is subject to fluctuations depending upon the changes in the demand and supply positions. Suppose the exchange rate between Indian rupee and the US dollar is determined by the demand for, and supply of, US dollar in the foreign exchange market. If dollar experiences greater demand, the value of dollar vis-a-vis Indian rupee will appreciate; or in other words, Indian rupee will depreciate vis-a-vis US dollar. On the other hand, if supply of US dollar increases, the reverse will be the case.

Floating rate system may be either independent or it may be managed. Theoretically speaking, there is no intervention by the central bank of a country in case of the independent floating. On the contrary, it does occur in a managed floating rate system. But the experiences show that intervention is a common phenomenon irrespective of the system being independent or managed. It is because of this fact that the IMF gives a clarification. If the purpose of intervention is to moderate the exchange rate and to check undue fluctuation, it will be an independent floating. But if the central bank intervenes to establish a level for the exchange rate, this will be a case of managed floating.

Now the readers must be anxious to know what is intervention. It is nothing but the sale and purchase of foreign currency by the central bank in the foreign exchange market in order to influence the demand and supply positions of the foreign currency and thereby to influence its value vis-a-vis the domestic currency. So if the Reserve Bank of India sells US dollar in the foreign exchange market, the supply of dollar will increase and rupee will appreciate vis-a-vis dollar. If it buys dollar in the market, demand for dollar will increase and rupee will depreciate vis-a-vis dollar.

Crawling Peg

Crawling peg is a compromise between fixed rate and floating rate regimes. The government maintains a fixed rate regime but devalues/re-values the currency periodically in order to keep the exchange rate abreast with the floating rate. With such adjustments, any difference between the real and nominal exchange rates does not last longer.



Target-zone Arrangement

Target-zone arrangement is found in case of countries forming some kind of regional monetary union. The intra-union exchange rate is fixed through the help of a common currency, although the member countries do have their own currency. This was the case with the EMU prior to 1999 when the European Currency Unit was the common currency. But the target-zone arrangement may take another shape when a single currency is in circulation throughout the union substituting the member countries' currency. In fact, this is now the case with the EMU.

Fixed Rates versus Flexible Rates

After delineating the features of the fixed and the floating exchange rate regimes, it would be worthwhile to pinpoint which one of the two is more suitable. The advocates of the floating rate argue that:

1. The exchange rate changes automatically with the changes in the macro-economic fundamentals. As a result, there does not appear any gap in the real and the nominal exchange rates. The economy remains free from any ill effects of the emergence of such a gap.
2. The floating rate regime possesses insulation properties meaning that the currency of a country is not influenced by the changes in the macro-economic fundamentals in the other country. In other words, currency shocks emanating in one country does not permeate to other countries.

The arguments do have reasoning but any large-scale fluctuation in the exchange rate depending upon changing macro-economic fundamentals and the psyche and behaviour of the participants in the foreign exchange market cannot be ruled out. MacDonald (1988) finds that the exchange rate changes among the countries on floating rate during 1973-85 were much more volatile than the changes warranted by the fundamental monetary variables.

Again, the insulation properties too are absent in many cases. Dunn (1983) finds that when the USA was pursuing tight monetary policy through raising the interest rate, the European countries had to raise interest rate so as to prevent large-scale capital outflow.

Yet again, the floating rate may not be suitable for many developing countries in view of their weak economic structure. It is our experience that the currency with weak economic support often tends to depreciate vis-a-vis strong currencies.

3.3 IMF AND INTERNATIONAL LIQUIDITY

It is true that the governments have been caring for liquidity in order to sustain international payments. This might be one of the reasons why mercantilists had advocated for maintaining trade surplus. But it is only since the establishment of the IMF that the issue of international liquidity is being given attention to. The IMF's role in this context needs some explanation in order to have a grasp of the international monetary system.

The Pool of Reserves with the IMF

The Articles of the Agreement of the IMF provided for the creation of a pool of reserves that was to be financed by the contribution of the member countries. A member country was to contribute to the pool equivalent to its quota that was determined on the basis of the member country's national income, foreign trade, etc. It meant that the size of the quota in respect of a developed member country was larger than that in case of a developing country. One-fourth of the quota was paid initially in form of gold and the rest was to be contributed in form of the member's



own currency, normally in form of non-interest bearing notes. This way the pool was created out of which the member countries could borrow to meet their balance of payment deficits, especially when such deficits were beyond their control.

For about first two decades, the funds flowed out of the pool in a big way to support the member countries' balance of payments. But then it was realised that the requirements of the member countries, especially the developing countries were too large to be met by the then size of the resources with the pool. The IMF took two measures. They were:

1. Creation of an international reserves assets, known as the Special Drawing Rights (SDRs) by amending the Articles of Agreement in 1969. The SDRs served the purpose of international money but its role was limited to unit of account.
2. Borrowing from the industrialised countries under the scheme, General Arrangements to Borrow (GAB) that was initiated in 1962. Again, in the wake of the Mexican crisis, the IMF initiated similar scheme, known as the New Arrangements to Borrow (NAB) in 1997.

The creation of SDRs went a long way. SDRs amounting to \$ 9.5 billion were created and allocated among the member countries during 1970-72 based on their quota. Again, SDRs equivalent of \$ 12.3 billion were created and allocated among the member countries. The third allocation equivalent of \$ 21.4 billion occurred during 1997, but it was limited to the transition countries that had shifted from a centrally planned economy to a market-based economy. These allocations helped improve the liquidity position of the member countries.

Again in order to make the system of international liquidity more viable, the IMF decided to reduce the role of gold in the international monetary system. It took a concrete shape with the second amendment to the Articles of Agreement that came into force from April 1978. SDRs came to be the principal reserve asset of the world monetary system. The role of gold as a common denominator of the par value of currencies ended in favour of the SDRs. The obligation to use gold in transaction with the IMF came to an end. SDRs replaced gold as a means of payment by the members to the IMF. This means that they were to pay 25 per cent of their quota to the reserves pool not in form of gold but in form of SDRs. The IMF sold 25 million ounces of gold and used the proceeds for the benefit of the poorer developing countries. Similar amount of gold was restituted to the members.

IMF's Funding Facilities

It has already been mentioned that the member countries borrow from the pool of reserves lying with the IMF. The funding facilities can be grouped as:

1. Permanent facilities for general balance of payments support:
 - a) Reserve tranche facilities
 - b) Credit tranche facilities
2. Permanent facilities for specific purposes:
 - a) Extended fund facility (EFF)
 - b) Compensatory and contingency financing facility
 - c) Buffer stock financing facility (BSFF)
 - d) Supplemental reserve facility (SRF)
3. Special Disbursement Account facility
 - a) Structural adjustment facility (SAF)



- b) Enhanced structural adjustment facility (ESAF), now known as Poverty reduction and growth facility (PRGF)

Reserve tranche drawings indicate unconditional borrowings of a part of the quota held by that particular member. A few experts do not consider such drawings as using IMF credit as it is the amount deposited by the borrower.

The credit tranche is often known as the IMF's basic financing facility. Such credits are made available in tranches-each tranche being equivalent to 25 per cent of the member's quota. The first tranche does not involve major conditionalities. The member country has simply to assure reasonable use of the funds. The subsequent tranches, however, require the performance criteria in terms of budgetary and credit policies. The policies are monitored by the IMF during the period in which the installments of credits are disbursed. The period of credit ranges from three to five years.

Extended Fund Facility was established in September 1974 for making available long-term resources in larger magnitude than available under credit tranches. It is provided when the balance of payments problem is structural. A member country can use the credit tranche and extended fund facility resources subject to an annual limit of 100 per cent of quota and a cumulative limit of 300 per cent of the quota.

The **compensatory financing facility** was established in February 1963. The credit is provided to meet the fluctuation in export earnings due to circumstances beyond the control of the member government. Since 1981, credit under this facility is also provided to cover the fluctuation in cereal import cost. The main gainers are the primary producing countries. The extent of the shortfall in export earnings is determined on the basis of relationship between the latest export preceding the request and the trend value of export earnings calculated as a geometric average. This facility was substituted by the **Compensatory and Contingency Financing Facility** in August 1988 by adding a mechanism for contingency financing to support the adjustment process approved by the IMF.

Buffer Stock Financing Facility was set up in June 1969. It assists mainly the primary producing countries in financing their contribution to international buffer stocks under international commodity agreements.

Supplementary reserve facility was created in December 1997 to provide assistance to those members that face exceptional balance of payments problem due to large short-term financing vis-a-vis sudden loss of market confidence.

Structural Adjustment Facility (SAF) was set up in March 1986 for providing additional balance of payments support in form of loans on concessional terms to low-income developing countries or to IDA-only countries. A member country can get such loans up to 70 per cent of its quota.

In December 1987, IMF set up **Enhanced Structural Adjustment Facility (ESAF)** for providing loans in addition to the SAF loans. Resources come from the ESAF Trust set up for this purpose, loans and contributions and the Special Disbursement Account. Such loans can go up to 185 per cent of the quota or even more in special cases. Interest rate on loans is very low (being 0.50 per cent). Maturity extends to 10 years.

The latest facility that the IMF has announced to set up is known as **contingent** credit lines. It is a precautionary line of defence against financial contagion. It will help countries with strong macro-economic policies against future balance of payments problem that may arise due to unjustified panic on the part of investors.



An Appraisal of IMF's Role

It is true that the IMF has done a lot to maintain and improve international liquidity. But the question is whether its role has been a complete success. A deeper probe reveals that the developing countries and particularly the low-income and the least developed countries have failed to get the desired amount of funds from the IMF. Broadly speaking, there are two reasons behind it.

The first reason is that the balance of payments support of the IMF is based on the quota of the borrowing country and not on the extent of its need. The low-income countries have a much lower quota and so they get only a little support irrespective of the fact that their need is far greater. Thus, unless and until the basis of the financial support is changed, these countries cannot get the required financial support from the IMF.

Second, the moment the borrowings of a member country exceed the sum of reserve trundle support and the first instalment of the credit tranche, the IMF imposes conditionality on the use of the funds. Low-income countries and the least developed countries lack efficient administrative capabilities with the result that they are not able to implement the policy guidelines suggested by the IMF and so they are not able to borrow more funds even if their quota permits to borrow more. Thus something needs to be done in this respect in order to benefit those who need it more.

3.4 SUMMARY

- International monetary system refers to the exchange rate arrangement and the international liquidity that facilitate the settlement of international payments.
- A couple of centuries ago, under an arrangement, known as the commodity specie standard, coins made of gold and silver facilitated international payments.
- Gold standard was a sophisticated version of commodity specie standard. It possessed the merits of automatic adjustment of exchange rates and balance of payments and of domestic price stability. But it could not go with monetary expansion plan; and as a result, it was abandoned.
- The immediate post-gold standard period witnessed upheavals in the international monetary system that led to the establishment of the IMF in 1945 in order to have a better monitoring of it.
- IMF adopted fixed parity system or the fixed exchange rate system, but there was room to make adjustments in the exchange rate in very specific cases.
- US dollar was the intervention currency in the fixed parity system. But with weakening of this currency since late 1950s, the system could not go a long way. Ultimately, it collapsed in February 1973.
- The new system, which is still in vogue, provided many options to the member countries, such as fixed exchange rate, floating exchange rate, crawling peg and target-zone arrangement. The options have merits and demerits. The member countries have adopted a particular option according to their own convenience.
- IMF, in order to provide international liquidity, maintains a pool of reserves created out of the contribution of the member countries based on their quota. The size of the pool was enlarged through borrowings from the industrialised countries under different schemes; and more importantly, through the creation of an international reserves asset, known as the SDRs.
- The member countries get the balance of payments support from IMF under different facilities.



- The international liquidity has improved over the years, but the low-income countries requiring greater balance of payments support from IMF have shared only a smaller part of the cake.

3.5 SELF ASSESSMENT QUESTIONS

1. Gold standard provided domestic price stability and automatic adjustment in balance of payments and in exchange rate. Discuss.
2. Mention the features of the fixed parity system of exchange rate. What were the causes behind its collapse ?
3. Do you agree that fixed exchange rate is better than floating rates ? Explain.
4. What do you mean by SDRs? How do they help improve international liquidity ?
5. What are the different facilities through which the member countries get balance of payments support from the IMF ?
6. Do you agree that the low-income countries do not get desired funds from the IMF ? Present your arguments.

3.6 FURTHER READINGS

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